

Department for Work and Pensions

Research Report No 628

Default options in Workplace Personal Pensions: report of a qualitative study

Chris Dobson, Stephen Hogan, Sarah Horsfield and Mark Winstanley

A report of research carried out by PricewaterhouseCoopers LLP on behalf of the
Department for Work and Pensions

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The Authors

Chris Dobson is a director in the PricewaterhouseCoopers LLP (PwC) Government and Public Sector practice. Prior to joining PwC, Chris worked for nine years in government, delivering a wide range of economics, research, policy and delivery work. He has held a number of senior roles in government (including a spell as a Senior Civil Servant) and two Director posts in different Non-Departmental Public Bodies. He was also Head of the Secretariat to Lord Turner's Pensions Commission. Chris has an MA Economics degree from Cambridge University, an MSc in Project Analysis, Finance and Investment and an MBA with Distinction. Chris can be contacted at chris.dobson@uk.pwc.com

Stephen Hogan is a consultant in the PwC Government and Public Sector practice. Stephen specialises in the development, evaluation, research and analysis of policy and strategy across the public sector, with wide-ranging experience of delivering policy, research and economics work across government. Before joining PwC in 2007, Stephen spent almost ten years working in the public sector, including a variety of roles in central and local government. He has a First Class BA Economics degree from Thames Valley University. Stephen can be contacted at stephen.j.hogan@uk.pwc.com

Sarah Horsfield is a consultant in the PwC Government and Public Sector practice. Sarah joined PwC in 2004 as an economist and has a broad range of experience in applying economics and analytical techniques across a range of issues and industries (both in the private and public sector). Sarah's particular areas of expertise and interest include the economic appraisal and evaluation of government policy. Sarah has a BA Economics degree from Cambridge University and an MBA with Distinction. Sarah can be contacted at sarah.horsfield@uk.pwc.com

Mark Winstanley is an actuary and investment adviser in PwC's pensions practice, with almost 20 years' experience in the pensions industry. Since joining PwC in 1998, Mark has advised both companies and trustees on all aspects of defined contribution pension provision and is responsible for PwC's research into providers of Workplace Personal Pensions. In addition, he provides training on behalf of the National Association of Pension Funds as part of their quarterly training courses to trustees. Mark has a BSc Mathematics degree from the University of Manchester, is a Fellow of the Institute of Actuaries and a Fellow of the Pensions Management Institute. Mark can be contacted at mark.winstanley@uk.pwc.com

Abbreviations

ABI	Association of British Insurers
AMC	Annual Management Charge
DB	Defined Benefit
DC	Defined Contribution
DWP	The Department for Work and Pensions
EBC	Employee Benefit Consultant
FSA	Financial Services Authority
GPP	Group Personal Pension
IFA	Independent Financial Advisor
IGG	Investment Governance Group
PADA	Personal Accounts Delivery Authority
PwC	PricewaterhouseCoopers LLP
SHP	Stakeholder pension
SIP	Statement of Investment Principles
SIPP	Self-Invested Personal Pension
TCF	Treating Customers Fairly
WPP	Workplace Personal Pension

Glossary

Active investment funds	Investment funds where the fund manager aims to outperform a benchmark/index by superior asset allocation and/or stock selection decisions.
Annual management charge (AMC)	A charge levied annually by a pension provider on a member's pension fund to cover the costs associated with providing that pension scheme. The charge is usually levied as a percentage of the total fund value.
Automatic enrolment	A pension scheme enrolment approach whereby an employer automatically enrolls eligible employees into its pension scheme. From 2012, a new duty will be placed on employers to enrol all eligible jobholders into a workplace pension arrangement that meets certain quality criteria and make a minimum contribution to that arrangement. Once enrolled, individuals can opt out of workplace pension saving, if they wish.
Basic State Pension	A non-earnings related pension paid by the State, based on the National Insurance contributions a person has paid, or been credited with, over the course of their working life.
Contract-based pension scheme	A defined contribution pension scheme purchased by an individual, either through their employer or individually, from a pension provider. It is owned entirely by the individual with the contract existing between the individual and the pension provider. It is also known as a personal pension.

Defined benefit (DB) scheme	An occupational pension scheme that provides pension benefits related to the member's salary or some other value fixed in advance.
Defined contribution (DC) scheme	A pension scheme that provides pension benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is annuitised.
Diversification of assets	The spreading of assets within a fund among different asset classes (e.g. equities, bonds, property), stocks (e.g. buying shares/bonds in different companies) and/or markets (e.g. UK, Europe, Japan), to reduce risk.
Employee Benefit Consultant (EBC)	An organisation that provides regulated financial advice to its clients (companies) on the use of pensions and other financial products.
Employer-sponsored pension scheme	A private pension scheme where membership is facilitated through an employer.
Group Personal Pension (GPP)	A form of employer-sponsored contract-based pension scheme. The employer facilitates access to the pension scheme but, as with all contract-based schemes, the legal contract existing is between the individual and pension provider.
Group Stakeholder Pension (Group SHP)	A special type of contract-based pension. They were introduced by the Government in April 2001 and comply with regulations that limit charges and allow an individual flexibility with respect to their contributions. Employers with five or more employees are required to provide access to a Group SHP pension scheme, unless they offer a suitable alternative pension scheme.
Group Self-Invested Personal Pension (Group SIPP)	A specific type of employer-sponsored contract-based pension scheme where the member has greater freedom over what to invest in.

Independent financial adviser (IFA)	An individual or organisation that provides regulated financial advice to its clients (companies or individuals) on the use of pensions and other financial products.
Lifestyle strategy	An investment strategy that automatically switches investments from more volatile assets into less volatile assets (relative to how the pension member is drawing their benefits) as the pension member approaches retirement. This can help to protect the member's fund to a certain extent from sudden movements in the market – thereby stabilising the fund value with which members can buy an annuity and/or take a tax-free cash sum at retirement.
Occupational pension scheme	An employer-sponsored pension scheme provided through a trust. Benefits can be defined contribution (DC) or defined benefit (DB).
Passive investment funds	Investment funds where the fund manager aims to perform in line with a particular benchmark/index.
National Employment Savings Trust (NEST)	As part of the 2012 workplace pension reforms, the Government plans to introduce a new low-cost, occupational pension scheme, currently known as NEST.
Personal pension	A contract-based pension scheme with the legal contract existing between the individual and the pension provider. Personal pensions can be provided as a part of an arrangement made for the employees of a particular employer (employer-sponsored DC contract-based scheme) or can be purchased by the individual (individual DC contract-based scheme).
Private pension	A pension that is not provided by the State.
Statement of Investment Principles (SIP)	Details the policy that controls how a pension fund invests.

Self-Invested Personal Pension (SIPP)	A specific type of contract-based pension scheme where the member has greater freedom over what to invest in. SIPPs can be available for individuals to take out on their own, as well as through an employer in a group scheme (Group SIPP).
Stakeholder pension (SHP)	A special type of contract-based pension that was introduced in 2001 by the Government and complies with regulations which limit charges and allows individuals flexibility around contributions. SHPs are available for an individual to take out on their own, as well as potentially through an employer in a group scheme (Group SHP).
Target-date funds	An approach to lifestyling that switch investments from more volatile to less volatile assets (relative to how members are drawing their benefits) based on the switches being completed by an expected retirement date, for example the '2020 fund'. Whereas in normal lifestyling the switches are carried out at member level, with target-date funds the switches are inherent within the investment fund.
Trust-based pension	An employer-sponsored pension scheme with the scheme taking the form of a trust arrangement (alternatively known as an occupational pension scheme). Benefits can be either defined contribution (DC) or defined benefit (DB).
Trustee	An individual or company appointed to hold assets for the beneficiaries of a trust-based pension scheme, in accordance with UK trust law.
Workplace pension	A pension scheme where membership is facilitated through an employer. There are two main types of workplace pension schemes: occupational schemes and workplace personal pension schemes.
Workplace personal pension schemes (WPPs)	An umbrella term used to cover Group Personal Pensions, Group Self-Invested Personal Pensions and Stakeholder Pensions.

Summary

Background

The Pensions Act 2008 sets out a series of measures aimed at encouraging greater private pension participation. From 2012, changes to the system will be introduced under which employers will have a duty to automatically enrol all eligible workers into a qualifying workplace pension scheme and to make contributions on behalf of those that do not opt out. Under the terms of automatic enrolment, every defined contribution (DC) pension scheme that an individual could be automatically enrolled into must have a default investment option.

The Department for Work and Pensions (DWP) has made a commitment to develop suitable guidance for pension providers to follow when offering a default option for workplace personal pensions (WPPs).¹ DWP issued draft guidance around the use of default funds for consultation in autumn 2009.

Research aims

The project sought to:

- review and analyse the available evidence on current and emerging practice regarding the use of WPP default options;
- gather the views and experiences of pension providers and other pension industry stakeholders to inform the shape of DWP's planned guidance;
- make recommendations for DWP to consider when producing its planned guidance; and
- discuss findings and recommendations from the work with DWP and other stakeholders.

¹ WPPs are a type of workplace pension scheme where the pension scheme is purchased by an individual from a pension provider (contract-based pension scheme). There are three main types of WPPs: Group Personal Pension schemes (GPPs), Group Stakeholder pension schemes (Group SHPs) and Group Self-Invested Personal Pension schemes (Group SIPPs).

The research was qualitative in nature and consisted of a literature review, interviews (with pension providers, employee benefit consultants and other industry stakeholders) and policy development workshops with DWP and other stakeholders.

The research was designed by DWP to focus on learning lessons from current market practice. It did not review theory, or make judgements about the appropriateness of current practice for current, or future, pension members.

Default options in WPPs: current practices

A default option is the investment option, selected by the pension scheme trustees, employer or provider, which is used when an individual pension member does not indicate an investment choice. It is also not unusual for some pension members to actively choose to invest in the default option. There are a number of steps that typically occur in the design, determination and selection of a WPP default option involving different stakeholders.

Despite a large range of investment choices typically offered to members of WPP schemes, the vast majority of individuals currently invest in the default option. For example, one of the providers we interviewed said that one of their schemes had 95,000 members, of which only 24 were not in the default fund. Limited research has been carried out into the characteristics of individuals who invest in WPP default options, although some evidence suggests that those with less financial awareness and access to financial advice may be more likely to use the default option.

When thinking about overall objectives for WPP default options, most pension providers interviewed said that their main aim was to match the investment strategy taken by the default option to the risk profile of the potential membership in the workplace. In terms of investment strategy, most providers have a preference for some diversification of assets, with use of de-risking² (typically a lifestyle strategy)³ as the member approaches retirement.

² Moving investment into assets which are considered to be less volatile and less risky.

³ A lifestyle strategy automatically switches investment from more volatile assets into less volatile assets as the member approaches retirement. This is usually done automatically via a predefined formula or algorithm, and is carried out on an individual basis. The lifestyling approach can help to protect a member's investment to a certain extent from sudden movements in the market – thereby stabilising the fund value with which members can buy an annuity and/or take a tax-free cash sum at retirement.

Some providers of WPPs used a document similar to a Statement of Investment Principles (SIP)⁴ to communicate investment information to members, but most relied upon other documentation, such as 'Key features' documents or 'Fund factsheets', which were generally said to cover similar types of information to SIPs. Poor member understanding of investments and risk was highlighted as an issue among most participants.

Views from pension industry stakeholders on DWP's future guidance

Many pension providers and intermediaries interviewed as part of the research were unclear about the need for DWP to issue guidance on default funds. Many stakeholders also questioned why the guidance was targeting providers of WPPs and not also providers of occupational (trust-based) schemes.

In relation to the design of default options, most participants felt that it was unnecessary and undesirable for DWP's guidance to attempt to alter market outcomes, since current practice was producing a good range of choice of default options for employers. Many participants had concerns that guidance that was overly prescriptive on the design of default options could stifle competition and innovation in the market, to the detriment of members.

In relation to the communication of default options to members, many participants suggested that DWP's guidance could have a role to play in encouraging more effective communication with members. It was also felt that DWP's guidance could improve market outcomes by encouraging stronger governance structures among providers and employers.

Most participants said the guidance needed to be issued at least 12 months in advance of the 2012 reforms, to give providers time to prepare. Some felt it was important that DWP's guidance took account of what was decided with regard to the default option for the NEST (National Employment Savings Trust)⁵. Many providers also had concerns about how DWP's guidance might fit in with other existing/proposed pension regulation – for example, the Financial Service Authority's (FSA) Treating Customers Fairly guidance.

Recommendations for DWP's guidance

Based on the work we have undertaken, we were able to report a number of recommendations to inform the draft guidance. These recommendations are based

⁴ SIPs communicate how the principle governing decisions about investments are made. The trustees of most occupational pension schemes are required to draw up a SIP and review it regularly, but SIPs are not a legal requirement for WPPs.

⁵ NEST is the new name for the personal accounts scheme.

solely on the research findings (i.e. current practice and the views of participants) and do not take account of wider potentially relevant evidence, such as finance theory or consumer preference theory. We recommend that DWP considers these additional areas when shaping its guidance. It will be important for DWP to:

- 1 Clearly communicate the need for this guidance, as a number of participants were not sure why DWP would need to issue guidance.
- 2 Consider extending the scope of the guidance or issuing additional guidance, to ensure that similar guidance is in place for both occupational (trust-based) schemes and contract-based DC schemes. DWP should also consider issuing guidance for employers, as well as pension providers.
- 3 Clarify the responsibilities of employers and providers in relation to WPP default options, as there appears to currently be some uncertainty around the respective roles of employers and providers in determining default options for WPPs. However, the DWP will need to discuss this with the FSA, to incorporate the FSA's requirements on providers and advisers.
- 4 Concentrate on high-level principles and processes to guide providers in the design of defaults, which will help to ensure minimum standards in the market and will support those providers who need it. Most participants believe that the guidance should be process driven, rather than being prescriptive about outcomes. Most participants felt that the market was already producing a good range of choice of default options for employers, including characteristics such as the de-risking of assets near retirement and some diversification of assets.
- 5 Encourage more effective communication with members. Poor member understanding of pensions and investment risk was highlighted as a concern by the majority of providers and Employee Benefit Consultants (EBCs) in our research; the guidance could help to ensure minimum standards are met by including a requirement for WPP providers to issue information on investment to members and prospective members that is most useful to them. The Department could also consider including suggested wording for providers to use to explain key investment concepts for members.
- 6 Outline minimum governance requirements for providers. The governance of WPPs was raised as a concern by some EBCs in our research; DWP should consider outlining what it deems to be 'best practice' in terms of provider governance structures, which might include suggestions around the frequency of reviews and their format, as well as recommendations on providers' disclosure of the performance of default options. If it was decided to issue guidance to employers, as well as pension providers, such guidance could include advice on employers' own structures for the governance and review of pension funds.

- 7 Take a lead in achieving more consistent risk ratings across pensions investments, for example through consultation. Our research found inconsistencies in how the risks of individual funds are rated, along with the inconsistencies in how individuals' risk preferences are assessed. Achieving consistency in the risk rating of funds and the risk profiling of individuals would make comparisons between funds much easier, and may also help pension providers and employers gain a better understanding of a particular workforce. It is clear that the issues are complex, and not everyone we spoke to was in favour of such a move, but DWP may wish to canvass views in the consultation guidance, or as a separate future consultation, on how such consistency could be achieved.

However, we are of the view that the following points need to be borne in mind when taking forward these recommendations:

- Evidence suggests that current market practice and the views of participants should not be taken as being perfectly aligned to an optimal approach to investment. Firstly, current practice cannot be assumed to be optimal from the point of view of member outcomes. Secondly, even if current practice is deemed to be optimal, it is possible that optimal WPP default practice and design may change from 2012, with possible changes in member participation, member characteristics and member risk preferences as a result of the reforms. It is our recommendation that DWP takes further time to consider these wider issues, as they suggest that basing future practice on current practice may not be wholly appropriate.
- A (minority) view was expressed in the course of our research that a light-touch, process-based approach to regulation in this area is not appropriate and more heavy-handed, outcome-based regulation would be better. We recommend that DWP gives this view careful consideration.

1 Background

1.1 Policy background

The Pensions Act 2008 sets out a series of measures aimed at encouraging greater private pension participation. The aim of these reforms is to overcome the decision-making inertia that currently characterises individuals' attitudes to pension saving and to make it easier for individuals to save for their retirement.

From 2012, changes to the system will be introduced that will place a duty on employers to automatically enrol all eligible workers into a qualifying workplace pension scheme, and to make contributions on behalf of those that do not opt-out. Eligible employees are those aged between 22 and State Pension age, earning above £5,035 a year at 2006/07 earning levels. A minimum employer contribution of three per cent on earnings between £5,035 and £33,540 will be required, with the total minimum contribution equalling eight per cent of that band of earnings (made up of employer contributions, worker contributions and tax relief).

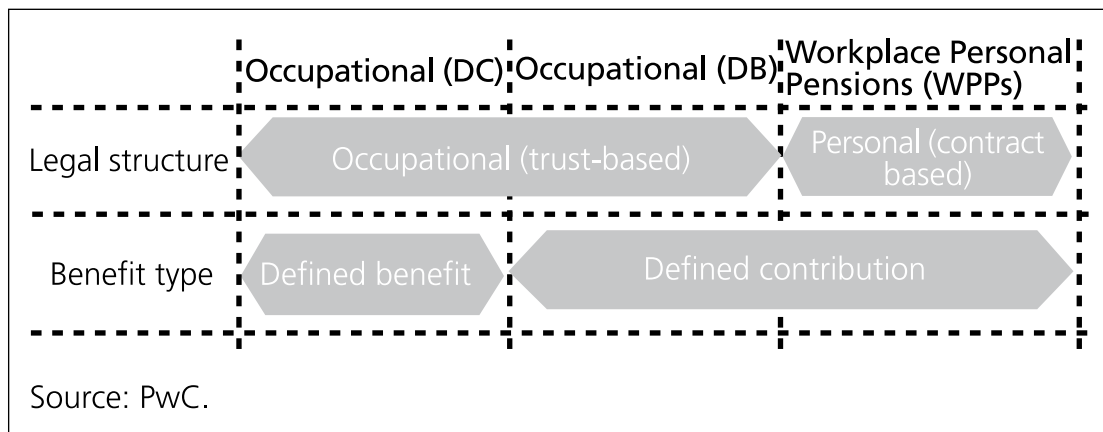
The Pensions Act also sets out plans for the establishment of a new national occupational pension scheme, the NEST (National Employment Savings Trust), which employers will be able to use as a qualifying scheme. This new scheme is being designed to be low cost and will ensure that all employers have access to a suitable qualifying pension arrangement to fulfil their new duties under the legislation.

Under the terms of automatic enrolment, every defined contribution (DC) pension scheme that an individual could be automatically enrolled into must have a default option. This is because individuals will not be expected to make an active choice as to where their contributions will be invested. Recent trends in pension provision and evidence from elsewhere suggests that use of the default option will dominate for new savers in 2012. It is clear that the design of default investment options across qualifying pension schemes is therefore likely to have a substantial effect on the pension outcomes of millions of people.

1.2 Workplace pension schemes

As shown in Figure 1.1, there are two main types of workplace pension schemes: occupational schemes and workplace personal pension schemes (WPPs). Occupational schemes can be either defined benefit (DB) or DC pension schemes. All WPPs are DC schemes.

Figure 1.1 Workplace pension schemes



Occupational (trust-based) schemes are set up by employers to provide income in retirement for their employees. The legal status of the pension sits under UK trust law and there is a board of trustees appointed to hold assets for the beneficiaries of the pension scheme. WPP schemes are, in contrast, pension schemes that have been purchased by an individual through their employer from a pension provider. These schemes are 'contract-based', in that the pension scheme is owned entirely by the individual and the legal contract exists between the individual and the pension provider.

Occupational schemes may provide pension benefits that are DB or DC. In DB schemes, the pension benefits provided to the member are predefined and related to the member's salary or some other value fixed in advance. In DC schemes, the pension benefits are based on the contributions invested, returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is annuitised.

All WPP schemes provide DC benefits. There are three common categories of WPP schemes:

- Group Personal Pension schemes (GPPs). GPPs can be described as a simple form of WPP. The employer facilitates access to the pension scheme but, as with all WPPs, the legal contract is between the individual and the pension provider.

- Group Stakeholder pensions (Group SHPs). Stakeholder pensions (SHPs) are a special type of pension scheme that were introduced in 2001 by the Government and comply with regulations which limit charges and allow individuals flexibility about contributions. Employers with five or more employees are currently required to provide access to an SHP pension scheme unless they offer a suitable alternative pension scheme. Employers are not, however, required to contribute to the scheme.
- Group Self-Invested Personal Pensions (Group SIPPs). These are a specific type of WPP where the member has greater freedom over what to invest in. Such arrangements are usually subject to charges greater than typically found with GPPs or Group SHPs.

The Department for Work and Pensions' (DWP's) guidance will be for pension providers offering a default option for WPPs after automatic enrolment is introduced in 2012. DWP's guidance is not currently intended to be directed at occupational (trust-based) workplace pension schemes, but we think that this is something the Department may wish to consider.

2 Project aims and research methodology

2.1 Research aims

The aim of our work was to carry out independent research and consultation to inform the Department for Work and Pensions (DWP) on the guidance it plans to issue for providers of workplace personal pensions (WPPs) from 2012. More specifically, the project sought to:

- review and analyse the available evidence on current and emerging practice regarding the use of WPP default options;
- gather the views and experiences of a selection of pension providers and other pension industry stakeholders on DWP's future guidance;
- make recommendations for DWP to consider when producing its planned guidance; and
- discuss findings and recommendations from the work with DWP and other stakeholders.

The study comprised desk-based research into current practice and interviews with a range of pension industry groups, including pension providers, intermediaries and other stakeholders. A number of specific topics and issues were examined as part of the research. These included, although were not limited to, the following:

- the key processes and decisions that are currently considered in setting up a WPP default option;
- the current approach to the design of WPP default options (asset allocation, fund management, approach to risk, etc);
- what objectives/statements of investment principles are currently used (if at all) for WPP default options;
- how objectives and performance of WPP default options are currently branded and communicated to members;

- changing and emerging market trends regarding the use of WPP default options;
- the feasibility of involving different stakeholders (employers, providers and members) in designing WPP default options in the future; and
- opinions from pension industry stakeholders about what DWP's guidance should look like (content, degree of prescription of the guidance, interrelationships between the guidance and the NEST (National Employment Savings Trust), etc).

2.2 Review of current market practice to inform future guidance

The scope of this research was to review current market practice, and consultee views, regarding the use of WPP default options. It was recognised as important that research, which seeks to inform the development of future guidance for WPP default options, should draw on current practice – since there is inevitably much expertise in the current pension provision market that can be drawn upon and learnt from to valuably inform DWP's future guidance.

It should also be emphasised, however, that current practice is not necessarily a good guide to what future practice should look like. There are two main reasons for this. Firstly, current practice cannot be assumed to be optimal from the point of view of member outcomes. Secondly, even if current practice is deemed to be optimal, it is possible that optimal WPP default practice and design may change from 2012, with possible changes in member participation, member characteristics and member risk preferences as a result of the reforms. This piece of work did not involve a wider consideration of these issues.

For this reason, it is important to recognise that this research will be one element of a range of evidence that DWP should draw upon when developing its guidance. Indeed, we understand that DWP has been engaged in other pieces of work which look more broadly than current market practice and will be used to inform the guidance.

2.3 Methodology

The majority of the research was conducted during July and August 2009. The research was qualitative in nature and consisted of three main elements:

- a high-level literature review of the existing available evidence on WPP default options;
- interviews with a range of pension industry stakeholders to supplement the literature review and gather views on what DWP's future guidance should cover; and
- workshops with DWP and other stakeholders to examine specific issues in more detail and test our findings.

2.3.1 Literature review

The aim of the literature review was to provide a synthesis of the existing available evidence on WPP default options. The review examined current market practice, as well as emerging trends in relation to the use, design, communication and governance of WPP default options.

The literature review sought to be high-level and broad in its scope. A comprehensive review of the literature was not within the scope of the work and has not been attempted. Neither was it within the remit of the work to undertake detailed analysis into any particular issues, to fill any gaps in evidence identified or to answer any emerging questions from the exercise.

A range of different sources were reviewed in completing the literature review, including:

- relevant legislation and regulatory guidance;
- government research and publications;
- information from regulators, industry bodies and the private sector;
- academic papers; and
- pension provider websites and other publicly available information.

The literature review did not consider finance theory, practice in wider markets or consumer preferences.

Where we report and refer to the findings of other research in this report, we do so without commenting on the robustness of the methodologies used in that research.

2.3.2 Industry interviews

The aim of the interviews was to supplement evidence from the literature review and to gather specific views from pension industry stakeholders about what DWP's guidance should cover.

A total of 14 interviews were conducted, of which six were with pension providers, four were with intermediaries/Employee Benefit Consultants (EBCs) and four were with other stakeholders, including the Financial Services Authority. In selecting the stakeholders for interview, PricewaterhouseCoopers LLP (PwC) sought to obtain a representative sample while ensuring that the tight timescales for this project were adhered to.

Topic guides for each interview category (stakeholder, provider and EBC) were prepared in advance and agreed with DWP. All interviews were conducted by PwC consultants and lasted for approximately 60 minutes. A preference for face-to-face interviews was made but, at the request of participants, three of the 14 interviews were undertaken by telephone.

2.3.3 Workshops

In order to examine specific issues in more detail and to test early findings from the literature review and interviews, three workshops and presentations were held in the latter stages of the project. A mix of senior staff from DWP and other industry stakeholders attended these workshops.

2.4 Report structure

The report now proceeds as follows:

- Chapter 3 discusses current and emerging practices in WPP default options. In particular, this chapter will discuss the use, design, communication and governance of default options in WPPs. Findings from both the literature review and stakeholder interviews will be presented.
- Chapter 4 discusses the views of participants on DWP's intended guidance on WPP default options.
- Chapter 5 summarises our key findings and identifies the implications of our work for DWP and recommendations.

3 Default options in WPPs: current practices

This chapter discusses current and emerging practice in default options in Workplace Personal Pensions (WPPs). Findings from the literature review and from the stakeholder interviews are presented. Five main areas are covered:

- Introduction to WPP default options. This includes a working definition of a default option, a brief explanation for why default options exist and a description of the processes and decisions that are gone through in designing and determining a WPP default option.
- Use of WPP default options. This includes an examination of how frequently default options are currently used by members of WPP schemes. It also discusses the membership profile of those who join WPP default options.
- Design of WPP default options. This includes a discussion of how WPP default options are typically designed, including the objectives/investment principles that are set for them, how investments are managed and implemented and emerging practice with regards to WPP default option design.
- Communication of WPP default options. This includes a discussion of how investment principles, objectives and performance of WPP default options are communicated to members. It also discusses issues around member understanding of investment issues.
- Governance of WPP default options. This covers the governance issues regarding WPP default options, including the governance structures that are typically used and their effectiveness in serving member needs.

3.1 Introduction to WPP default options

This section discusses the processes and decisions that typically take place in determining a WPP default option.

3.1.1 Definition of a default option

A default option is the investment option, selected by the pension scheme trustees, employer or provider, which is used when an individual pension member does not indicate an investment choice. In addition, it is not unusual for some pension members to actively choose to invest in the default option.

3.1.2 Need for default options in pension schemes

In a purely rational world, we might expect that there would be no need for default options in pension schemes. Members of pension schemes have income profiles and risk preferences which differ on an individual by individual basis. We might therefore expect that individual members would select an investment option for their pension contributions to meet their specific circumstances and needs (for example, a particular risk and reward profile which matches their individual risk preferences).

In reality, and as discussed in more detail in Section 3.2 below, the majority of members of pension schemes will not select a specific investment option that matches their individual needs but will instead enter the default option.

Psychological and other factors have been presented as providing explanations for such behaviour. These include the existence of myopia (tendency for individuals to be short-sighted in their planning), procrastination and inertia (tendency for individuals to put off thinking about the future or to not think about it all) and general apathy, as well as a lack of confidence among individuals when it comes to making financial decisions. This has been documented through behavioural economics literature from the Pensions Commission and others⁶.

The use of default options reduces the decision-making activity required of individuals and can arguably be seen as a way of encouraging participation in private pension saving. In the interviews conducted as part of this research, many participants reported that use of the default option was necessary to encourage greater participation in WPPs, since members did not typically like selecting an investment option themselves.

'We would prefer not to have to offer a default – but it is needed as people are not always willing to choose a pension scheme'

(EBC interview)

⁶ See, for example, Pensions Commission, 2004, *Pensions: challenges and choices: the first report of the Pensions Commission* and Wicks et al., 2008, *Incentives to save for retirement: understanding, perceptions and behaviour: a literature review*, DWP Research Report No. 562.

'Members [opt for defaults as they] want experts to make the decisions'

(Provider interview)

The 2012 workplace pension reforms aim to overcome the inertia that currently characterises individual behaviour with respect to pension saving. Under the terms of automatic enrolment, every pension scheme that an individual could be automatically enrolled into must have a default option. This is because individuals will not be expected to make an active choice as to where their contributions will be invested.

Workplace Pension Reform

The Government estimates that around seven million people are not saving enough to meet their retirement aspirations.⁷

In response to this challenge, the Government is making changes to the pension system. From April 2010, changes to the state pension will make it fairer, simpler and more widely available for women and carers. The state pension will be a foundation for retirement, but most people will want more on top. To encourage people to save in a private pension, the Government is planning to introduce workplace pension reforms from 2012.

From 2012, employers will be required to automatically enrol all eligible jobholders⁸ into a qualifying workplace pension and to make minimum contributions into it. The employer duties will be staged in over a four year period, starting with large employers, medium and then small.

Employers will need to contribute a minimum of 3 per cent on a band of the eligible jobholder's earnings – between £5,035 and £33,540⁹ a year (minimum contributions apply only to money purchase pension schemes¹⁰). This will be supplemented by the jobholder's own contribution and around 1 per cent in the form of tax relief. Overall contributions must total at least 8 per cent.

The minimum employer contribution levels will be phased in, starting at 1 per cent, moving to 2 per cent and finally 3 per cent.

Employers will be able to choose the qualifying pension scheme(s) they want to use (including their current scheme), provided the scheme(s) meet certain quality criteria.

⁷ This figure is based on DWP modelling using data from the English Longitudinal Study of Ageing (ELSA) and was published in the May 2006 White Paper, Security in retirement: towards a new pension system.

⁸ Eligible jobholder is a person working in Great Britain aged at least 22 years old, who has not yet reached State Pension age and is earning more than £5,035 a year.

⁹ The earnings figure is in 2006/07 terms and will be updated for 2012.

¹⁰ Defined Benefits pension schemes can also be used.

Workplace Pension Reform (continued)

A new simple, low-cost pension scheme, NEST (National Employment Savings Trust), will be introduced as one such qualifying scheme. The intention is that the scheme will operate like any other trust based, multi-employer occupational pension scheme, but it will be focused on a target audience of low to moderate earners.

Source: DWP

3.2 Use of WPP default options

This section will discuss use of WPP default options – including how frequently default options are offered and selected by members and what the evidence regarding the membership profile of someone entering a WPP default option is.

3.2.1 Frequency of use of WPP default options

Findings from the literature review reveal that, despite a large range of investment choice typically currently offered to members of WPP schemes, the majority of individuals currently invest in the default option.

Recent qualitative research carried out for the Department for Work and Pensions (DWP) into current practices in the WPP market indicated that providers of Group Personal Pension schemes (GPPs) typically offer anything between 40 and 500 fund choices, with 150 fund choices being typically offered.¹¹ The same research showed that providers of Group Stakeholder pension schemes (Group SHPs) typically offered fewer choices (from 10 to 150 funds), with 35 funds being typically offered.

As previously discussed, it is a legal requirement that a default option is offered in the case of SHPs. Although this law does not apply to GPPs, the same DWP research found that 80 to 90 per cent of employers did select a default option for their employees.

Where a default option is offered, evidence suggests that the vast majority of individuals invest in it. In the DWP research referred to above, intermediaries and employers reported that between 60 and 100 per cent of members tended to invest in the default option, depending on the employer. Research conducted elsewhere reveals similar results. For example, the 2008 National Association of Pension Funds survey (although covering occupational as well as WPP schemes)

¹¹ Wood, A. *et al.*, July 2009, *Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries*, DWP Research Paper No. 591.

reported that in 'most' cases members tend to use the default option rather than selecting their own investment options.¹²

Findings from the interviews undertaken for this research support the above results. Most providers reported that the majority of members invest in the default option:

'One scheme has 95,000 members and only 24 of them are not in the default option'

(Provider interview)

One Employee Benefit Consultant (EBC) reported that the proportion of members in default options is generally underestimated, while another provider believed that there is likely to be an increase in the proportion of members choosing the default option:

'The default option will be the right thing for even more people'

(Provider interview)

3.2.2 Profile of WPP default option members

The literature review revealed that limited research has been carried out into the characteristics of individuals who join WPP default options (as opposed to selecting alternative investment choices). Findings from the interviews supported this, with most providers and employers having very little information about the characteristics of individuals who enter default options, including the proportion of members who end up in defaults 'by default' versus those who more actively consider the investment options available and make a deliberate decision to select the default option.

One change noted is that providers no longer automatically receive the application forms completed by members and may rely solely on data provided by the employer. Although the contract is between the member and the provider it is the employer who normally issues an application form, to ensure that it has authority to deduct contributions through its payroll. Some providers no longer require application forms completed by the member; they therefore rely instead on data that is provided by the employer.

One provider suggested that members with higher levels of financial capability are less likely to become members of the default option.

'Anecdotal evidence suggests that those who do not opt for the default option are those members who are more financially aware and are members of a scheme with a full advice service'

(Provider interview)

¹² NAPF, 2008, Annual Survey. The NAPF survey is based on a sample size of approximately 300 defined contribution schemes responding.

This is supported by recent research carried out by DWP which found that the proportion of members that invested in the default option was believed to depend on the extent to which members received one-to-one communication and advice, which itself depended on how engaged the employer was in providing employees with access to such advice.¹³

In 2007, Byrne *et al.*, conducted some research into the use of the default option in a single, large, defined contribution (DC) scheme.¹⁴ They found that use of the default option varies with certain factors, in particular:

- Use of default declines with tenure – those individuals who had been in the pension scheme for a longer amount of time were less likely to use the default option (suggesting that members initially take the default, but eventually get around to make an active choice);
- Use of default declines with income – higher paid members are more likely to make an investment choice and are less likely to accept the default option.

Overall, a lack of evidence around the characteristics of those who enter WPP default options may simply reflect the sheer numbers of those entering the default option. One provider remarked that there was little point doing research into the characteristics of those who entered the default since so many members took this route, which therefore indicated that ‘all types of people enter the default’.

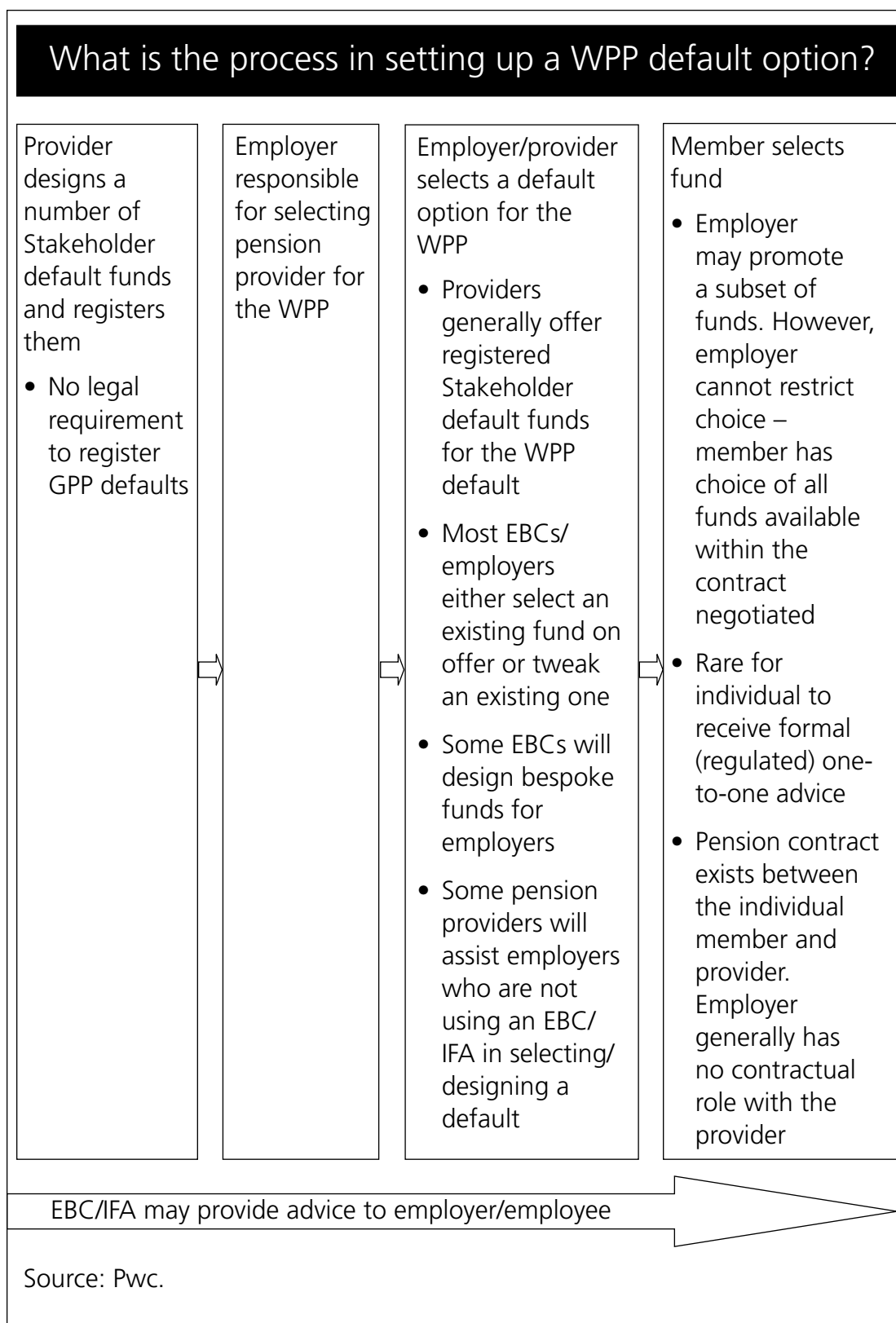
3.2.3 Process in setting up a WPP default option

Figure 3.1 illustrates the main steps that typically occur in the design, determination and selection of a WPP default option. As can be seen, a number of different stakeholders are typically involved in the process.

¹³ Wood, A. *et al.*, July 2009, *Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries*, DWP Research Paper No. 591.

¹⁴ Pensions Institute, Byrne *et al.*, September 2009, Pension plan decisions: discussion paper PI – 0903. Data used relates to the period of 12 months ending May 2006. 3696 members were in the scheme examined.

Figure 3.1 Typical process of setting up a WPP default option



It is a legal requirement that all stakeholder pension schemes (SHPs) have a default option and pension providers are legally required to register the default options they use for SHPs. This means that providers typically have a 'ready made' selection of possible default options. Pension providers are not legally required to register default options that they use for GPPs.

The employer who facilitates the WPP is initially responsible for selecting the pension provider for the WPP. In making this selection, the employer may seek advice from an intermediary (such as an independent financial adviser (IFA)) or Employee Benefit Consultant (EBC).

The pension provider and employer (perhaps, again with support from the EBC) are then responsible for selecting the default option for the WPP. Findings from the interviews conducted reveal that providers generally offer registered SHP default options to employers in the first instance.

Most employers will select an existing default option offered by the provider if they are not being advised by an EBC (or Independent Financial Advisor (IFA)). If an EBC (or IFA) is involved in advising the employer, then normally either an existing default option is selected or a slight alteration is made to one of the existing options. Some EBCs will design bespoke default options for employers. In certain instances, some pension providers will assist employers who are not using an EBC to design or select a default option.

As part of the WPP scheme that an employee is a member of, the employee is then offered a range of funds in which to invest. This range includes the default option which the member would become part of should they make no other active choice of fund. The choice of funds offered to the individual is the full range of investment funds available under the WPP contract selected by the employer. The contract in place exists between the individual and the pension provider and the employer cannot restrict the choice of funds available to the individual member. Some employers may, however, promote a subset of funds to members which they deem most appropriate.

It is rare for individuals to receive formal (regulated) one-to-one advice on their investment choice. However, in some instances employees may have access to an IFA, which is paid for either through commission from the pension provider (and hence higher charges on the member's invested funds) or through separate fees.

Once the individual's investment choice has been confirmed, pension contributions will start to be made (either by the employee, employer or both) into this option. The pension provider will be responsible for administering and managing the funds of the pension scheme on behalf of the members (although some investment funds may be managed by external investment managers). The employer's role in relation to the pension scheme will generally be to collect/remit contributions to the provider and provide information such that the contractual relationship between the individual and the pension provider can continue to function effectively.

3.3 Design of WPP default options

This section discusses how WPP default options are typically designed, including the typical overall objectives for WPP default options, the investment strategies that are typically implemented and emerging practice with respect to use of new approaches and products.

3.3.1 Overall objectives for WPP default options

During the interviews, participants were asked about the objectives they had for the WPP default options they provided. EBCs typically stated that the main objective of their WPP default funds was to meet individuals' needs (the pension contract in WPP pension schemes is between the provider and the individual), by attempting to match the investment strategy taken by the default option to the risk profile of the potential membership in the workplace. Specific issues that were considered when thinking about objectives for WPP default options included the following:

- selecting a default that is felt to be suitable for the majority of members;
- meeting the requirements of the type of person who is going to use it;
- trying to deliver on members' reasonable outcomes and expectations;
- establishing the objectives for the members and trying to meet these;
- finding the most appropriate fund to cater for most risk appetites;
- considering the default option within the general overall risk tolerances of the members; and
- selecting a default option that is easily explainable to members.

3.3.2 Investment strategy and management

In terms of investment strategy, findings from the interviews and literature review indicate a preference for some diversification of assets in current WPP default options, with use of de-risking strategies¹⁵ as the member approaches retirement. Regarding costs, most providers felt that costs were important but were not of the highest priority when it came to selecting an appropriate default option. In addition, many providers noted that costs were not a great consideration in the design process as long as they were reasonable.

Most providers prioritised maximising exposure to equity returns as long as possible before switching investment into less volatile asset classes, such as cash and bonds, as the member gets closer to retirement. In practice, this meant implementation

¹⁵ Moving investment into assets which are considered to be less volatile and less risky.

of a lifestyle strategy for most providers.¹⁶ Findings from the literature review also support this. In the 2008 NAPF survey, 89 per cent of schemes reported using a lifestyle strategy for their default option.¹⁷

Lifestyling strategies frequently use investment in equities for the 'growth stage' of investment, switching progressively to a final year allocation that combines bonds and cash. Our interviews found that the most common method of implementing lifestyling was to begin with 100 per cent investment in a global equity fund, moving to a final allocation of 75 per cent bonds and 25 per cent cash – with the switch typically starting five to ten years before retirement. Some providers were moving towards using a diversified fund of alternative asset classes (e.g. a Diversified Growth Fund) up to the period when switching commences.

However, findings from the literature review indicate that the way in which lifestyle strategies are implemented can vary quite significantly. In a study of 31 pension plans, Blake *et al.*, found significant variation in the mix of assets typically utilised and the time period over which the lifestyling process is implemented.¹⁸ The 2009 PensionDCisions DC Sponsor Default Survey found that 70 per cent of plans use a 100 per cent allocation to equity funds as the default, but that regional allocations within equity strategies varied significantly, with allocations to UK equities varying by between 34 and 100 per cent.¹⁹

In terms of investment management performance, many providers noted the importance of ensuring that the investment performance of default options did not become too far removed from the average performance or funds for that asset class (either through significant under or over performance). In practice, this typically meant using passive management of funds as opposed to active investment management techniques. Where multi-asset funds were used in the 'growth stage' of the lifestyle strategy, asset allocation is typically actively managed, although some of the underlying components of the funds may be passively managed.

¹⁶ A lifestyle strategy automatically switches investment from more volatile assets into less volatile assets as the member approaches retirement. This is usually done automatically via a predefined formula or algorithm, and is carried out on an individual basis. The lifestyling approach can help to protect a member's investment to a certain extent from sudden movements in the market – thereby stabilising the fund value with which members can buy an annuity and/or take a tax-free cash sum at retirement.

¹⁷ NAPF, 2008 Annual survey.

¹⁸ Blake *et al.*, July/August 2007, Default funds in UK defined contribution plans.

¹⁹ PensionDCisions in association with Incisive Media, 2009, Default investment strategy survey. The survey covered 45 large UK DC plans, representing half a million DC members.

Where passive equity funds are used the annual management charges (AMCs) are typically similar to the AMCs applied to the pension provider's own actively managed investment funds. However, where the provider offers actively managed funds through external fund managers the AMCs will be higher.

3.3.3 Emerging practices

For many providers interviewed, their strategy with regard to WPP default options had not appeared to have changed much in recent years. Some providers highlighted the use of some emerging practices with regards to their design of WPP default options.

An increased use of 'target-date' funds, for example, was reported by some providers. Target-date funds, popular in the United States, are an approach to lifestyling which switch the investments from more volatile to less volatile assets (relative to how members are drawing their benefits) based on the switches being completed by an expected retirement date, for example the '2020 fund'. Whereas in normal lifestyling the switches are carried out at member level, with target-date funds the switches are carried out for all members at the same time across the whole investment fund. An advantage of target-date funds is thought to be that they can be easier to communicate to members than traditional lifestyle funds. For larger schemes, implementing 'lifestyle' switches at a fund level, as for target-date funds, can be more efficient than implementing switches at a member level, as occurs in typical lifestyle strategies.

Other providers highlighted the use of alternative approaches. For example, one provider is considering offering funds that use derivatives to guarantee that the return on the fund cannot fall below a certain level, but at the same time restricting the potential upside returns on the fund. Another provider offers a fund which moves a member's investments into safer asset classes when investment performance meets a predetermined level.

The current market environment may be a factor causing providers to reconsider their approaches to management of default options. In the 2009 DC Sponsor Default Survey, 20 per cent of pension plans stated that they were considering changing their default in light of the current market environment.²⁰

3.4 Communication of WPP default options

This section will discuss how investment principles/objectives for WPP default options are communicated to members, including use of Statements of Investment Principles (SIPs). It includes a description of how the performance of WPP default options is typically communicated to members and discusses concerns some participants had around members' understanding of investment issues.

²⁰ PensionDCisions in association with Incisive Media, 2009, Default investment strategy survey. The survey covered 45 large UK DC plans, representing half a million DC members.

3.4.1 Use of Statements of Investment Principles

Statements of Investment Principles (SIPs) communicate how the principles governing decisions about investments are made. The trustees of occupational pension schemes are required to draw up a SIP and review it regularly but SIPs are not a legal requirement for WPPs.

Nevertheless, some providers in the interviews conducted said that they issued documents similar to SIPs (but not called a SIP) for their WPPs. In general, where used, SIPs covered the following:

- The broad objectives of the default option;
- A description and explanation of the investment choices applied;
- An explanation for how the default option had been designed to meet members' risk profiles; and
- Explanation and detail around how corporate governance and socially responsible investment issues were considered through the investment strategy.

Where SIPs were not used, a variety of documents such as 'Key features' documents and 'Fund factsheets' were generally used instead by providers to communicate key information to members. These were generally said to cover similar types of information to SIPs and in a similar level of detail.

3.4.2 Communication of investment strategy to members

As discussed above, most WPP default options use a lifestyle strategy. Investing in a lifestyle strategy involves transferring investment from certain categories of funds (generally higher return, higher volatility funds involving, for example, equities) to other categories of funds (generally lower return, lower volatility funds involving, for example, bonds or cash) over the lifecycle of the investment. For this reason, it is not usually practical to specify particular benchmark returns for the default lifestyle option as a whole. Instead, providers often communicate a broad aim for the lifestyle strategy as a whole to the member and then provide more specific benchmark objectives for the individual funds invested in.

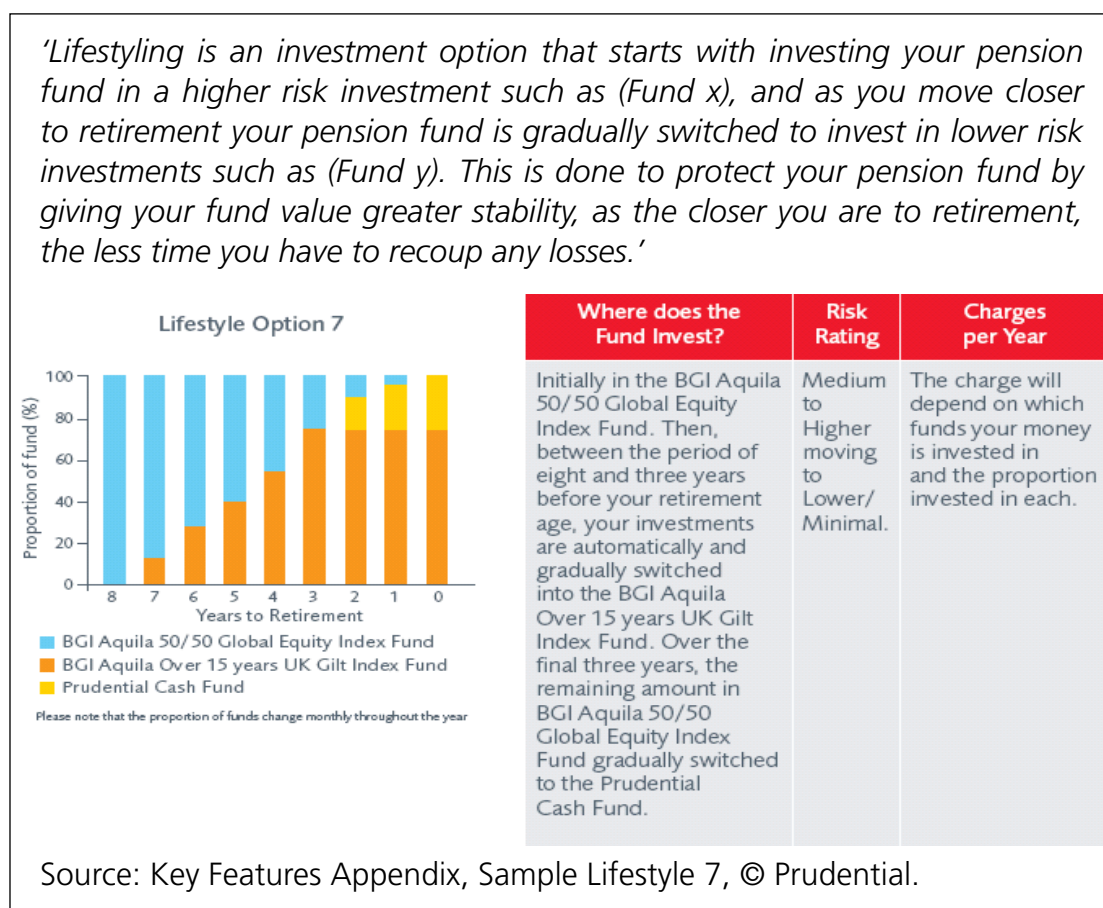
An example of how a pension provider might typically communicate a lifestyle default option to members is provided in Figure 3.2. The provider would usually communicate a broad and high-level objective for the lifestyle strategy in terms that are likely to be understood by the member – for example, explaining that the lifestyle strategy aims to maximise returns through higher return, but higher risk, funds in earlier years, before transferring into less volatile investments close to retirement. In many instances, the provider will specify details of how this investment profile maps over time – as per Figure 3.2. The provider will also usually provide details of the charges.

Some providers communicate risk-ratings for the default options provided (as in Figure 3.2). This will sometimes include a 'risk-rating tool' that members can use to help them identify their own risk preferences. Some providers noted an increased

use of risk-ratings for default options in recent years as an attempt to deal with problems associated with poor member understanding (see Section 3.4.4).

In addition to the above information, members typically have access to more detailed information on the objectives and benchmark returns set for the specific funds making up the lifestyle option. Where funds are passively managed, the fund objective will typically be to track an appropriate index or benchmark. Where funds are actively managed, the aim of the fund will typically be to outperform an index or benchmark. Some participants felt that objectives should focus more on the level of pension a member might require at retirement.

Figure 3.2 Example of provider communication about a lifestyle default option



3.4.3 Communication of WPP default options performance to members

Providers interviewed tended to take relatively similar approaches when it came to updating members on the performance of WPP default options. Most providers make quarterly information factsheets on the performance of the funds that make up the default option available to members. Members also usually receive an annual statement explaining how their individual pension scheme has performed over the year. Members can also request up-to-date valuations of their pensions at any time.

3.4.4 Members' understanding of investment issues

Several providers and EBCs highlighted concerns they had around members' understanding of investment issues.

'Most members don't understand what their pension is.'

(Provider interview)

'Some people are sleepwalking into default options.'

(Provider interview)

Our literature review highlighted members' generally low financial capability and poor understanding of pensions in general as a significant issue. Research has shown that even relatively basic subject areas create confusion for many when it comes to pensions. For example, a survey carried out by the Association of British Insurers (ABI) found that 45 per cent of people thought that a pension and an annuity were the same thing;²¹ another survey found that 42 per cent of consumers were unaware that it is possible to receive tax relief on pension contributions.²²

Poor pension provider literature was blamed by some providers and other participants for being unnecessarily complex and thereby creating confusion among members. One provider had carried out qualitative research in 2008 with members and found that their communication material was generally too detailed and that members were not able to use or understand it. One provider also commented that members 'did not like the scare tactics used in some material which tries to force people into pensions'.

Despite the above, many providers and EBCs commented that regardless of the approach taken to communication with members, the majority of members would fail to read any of the literature provided and fail to be engaged at all in the decision-making process. Some providers felt that members believe the default fund is a 'safe harbour' as it had been chosen for them.

Findings from the literature review indicated that sustaining member confidence in pension schemes is critical in respect of long-term member outcomes. The Personal Accounts Delivery Authority (PADA) believes that the impact of contribution breaks (i.e. periods of not investing in a pension scheme) on expected retirement incomes is greater overall than the impact of flat investment performance.²³ This means that engendering confidence in pension schemes so that members continue to

²¹ ABI, 2005, *Serious about saving – annuities: bonus or burden?*

²² National Association of Pension Funds (NAPF), 2009, *Workplace Pensions Survey*.

²³ Personal Accounts Delivery Authority, May 2009, *Building personal accounts: designing and investment approach. A discussion paper to support consultation*.

make regular contributions into them is vital. However, the recent financial crisis may have reduced confidence in pension saving – the number of people who said nothing would persuade them to increase pension saving was recently found to be at its highest level in more than three years.²⁴ An important element of member communication is ensuring that individuals understand the long-term benefits of pension saving and do not opt out of schemes as a result of short-term fluctuations in investment performance.

3.5 Governance of WPP default options

This section covers a discussion of some of the governance issues regarding WPP default options, including the governance structures that are typically used for WPPs and the evidence available on the effectiveness of such structures.

3.5.1 Governance processes for WPP default options

WPPs are contract-based schemes, with the legal contract existing between the individual and the pension provider. Unlike occupational workplace pension schemes, which have a board of trustees responsible for acting in the best interests of the scheme beneficiaries, members of WPPs have no such entity recognised in law or regulation acting solely on their behalf.

Providers of WPPs fall under Financial Services Authority (FSA) regulation. This includes requirements relating to the prudent running of a provider's business, effective promotion and communication of products, paying due regard to the interests of customers and treating customers fairly²⁵.

The employer role with regard to WPPs is mainly an 'enabling' role – allowing the individual pension member and provider to contract together effectively by ensuring sufficient information is provided to both the member and provider and by collecting/remitting contributions as required. The literature review and interviews highlighted that some employers do commit to additional governance arrangements with respect to WPPs. However, these are voluntary and conducted by the minority of employers only. Examples of such additional commitments include:

- Regularly reviewing the WPP contracts, perhaps with the support of an EBC.
- Formal governance or management committees to periodically review the suitability of the contract and respond as required.

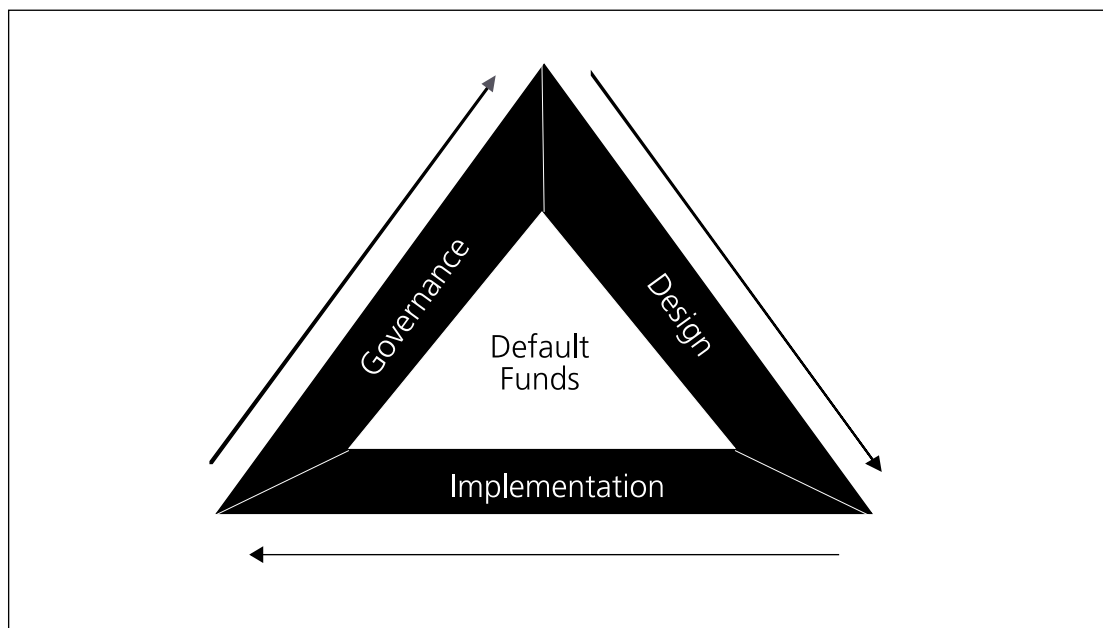
²⁴ Association of British Insurers (ABI), January 2009, Research brief: Q4 2009, ABI savings and protection survey. Fieldwork for the survey was conducted online by YouGov and was based on responses from 2,779 British adults aged between 18 and 70.

²⁵ The Pensions Regulator (tPR) also has some regulatory responsibilities relating to WPPs.

- Staff forums or consultations with employees to obtain and respond to feedback from employees on the suitability of WPP scheme arrangements.

The design, implementation and governance of default funds should be seen as part of a continuous process (as outlined in Figure 3.3), where the results of any governance reviews may lead to further reviews of the actual design process.

Figure 3.3 The continuous governance process



3.5.2 Effectiveness of governance processes for WPP default options

In recent years, there has been much commentary around a so-called 'governance gap' for contract-based schemes compared to occupational pension schemes. It was argued by some of the participants we spoke to in our fieldwork, and in some of the research we reviewed in our literature review, that the majority of members of such schemes do not understand the investment risks they face and that the default options they are investing in are often not appropriate for their needs.

The Pensions Institute define governance in DC schemes as being about '*helping members to make appropriate investment choices*'.²⁶ In their discussion paper '*Defined contribution pensions: dealing with the reluctant investor*', they cite survey results which find that, on average, most pension experts think that only ten to 15 per cent of DC scheme members understand the investment risks they face (although it is worth noting that this was a small survey).²⁷ In addition, the

²⁶ The Pensions Institute, 2007, *Defined contribution pensions: dealing with the reluctant investor: Innovation and governance in DC pension investment*.

²⁷ Online survey completed in 2006 by 54 professionals from the DC pensions market. Respondents included individuals who worked for fund management companies, pension scheme providers and pension consultancy firms, as well as pension lawyers and professional trustees.

Pensions Institute found that 69 per cent of the pension experts surveyed say that the typical investment arrangements in UK DC pension plans do not meet most members' needs.

The Pensions Institute argue that research conducted by them indicates that what most DC members want is not more or clearer information, but rather for an expert to make their investment decision for them. The problem, it is argued, is that many employers and pensions professionals are reluctant to offer any form of investment advice to individual members because they are afraid of legal liability if the outcome is unsatisfactory. This problem is accentuated by the fact that, through the act of offering a default option, many members may actually assume that that default has been chosen to meet their specific needs.

The Pensions Institute has argued that regulators should encourage employers, trustees and advisers to take a greater fiduciary role in assisting members by protecting them through 'safe harbour' rules that restrict liability, provided due diligence has been performed. This would include selection of the default option and determining the nature of the information and advice that is provided to members.

Throughout the interviews conducted for our research, many participants (providers, intermediaries and others) also recognised a weakness in current governance arrangements for WPP schemes.

Many participants also referred to some 'bad press' that lifestyle strategies have received lately. Such arguments typically relate to lifestyle strategies being too blunt, not matching members' needs and being too difficult to communicate to members. While recognising these arguments, most participants supported the use of lifestyling, arguing that it was often the most appropriate overall strategy for default options.

Findings from the literature review support these findings. While there is much criticism of lifestyling as an investment strategy, there appears to have been little overall research into identifying investment approaches which would more effectively match up with current WPP default members' risk preferences.

4 Views from pension industry stakeholders on DWP's guidance

4.1 Introduction

The previous chapter discussed findings from the literature review and stakeholder interviews regarding current and emerging practice in Workplace Personal Pension (WPP) default options.

This chapter will discuss views from the interviews we conducted with pension providers, Employee Benefit Consultants (EBCs) and other pension industry stakeholders on the Department for Work and Pensions' (DWP) proposed guidance for providers of WPPs from 2012.

A number of different aspects of the guidance were discussed during our interviews.

This chapter will cover:

- general comments on the guidance;
- topics that participants felt the guidance should address; and
- other issues raised by participants.

4.2 General comments on the guidance

This section summarises some of the general and most important comments those interviewed had about DWP's proposed guidance – particularly looking at the need for the guidance, the target for the guidance and other general issues participants raised in relation to the guidance.

4.2.1 The need for the guidance

A significant proportion of providers and EBCs interviewed were unclear about the need for DWP to issue this guidance. They were unclear about what the benefits from the guidance were expected to be and whether any benefits would outweigh any negative impacts that the guidance might have.

4.2.2 The target for the guidance

Many stakeholders questioned why the guidance was targeting providers of WPPs and not including occupational (trust-based) schemes. It was felt that if guidance was desirable for the development of appropriate default options for WPP schemes, it would also be desirable for the development of appropriate default options for occupational schemes. Concerns were also raised around there being a 'level-playing field' between occupational and contract-based schemes. Some thought it 'unfair' that guidance should be required in one instance but not in the other.

Some stakeholders also suggested that guidance for employers might also be valuable – possibly in addition to any guidance issued to providers. It was felt that employers potentially have a very significant role in shaping WPP default options and outcomes for members but that, currently, there is a lack of clarity around what employers should be doing with respect to WPP schemes, in particular where an employer is not taking advice from an Independent Financial Advisor (IFA) or EBC.

4.2.3 Concerns raised around the guidance

For the majority of pension providers and EBCs interviewed as part of this research, the main concern they had with respect to DWP's guidance was that it should not be too prescriptive. It was felt that guidance that was too prescriptive could 'stifle' the market and hamper innovation. The general feeling was that this would do more harm than good with respect to the future development of the WPP default option market and impact on members.

'If the guidance is too prescriptive then this will stifle innovation and result in members making the wrong decisions'

(Provider interview)

'The guidance should be loosely drawn and non-prescriptive'

(Provider interview)

Some providers and intermediaries were worried about the compliance responsibility implications of any guidance issued. It was generally felt that the more high-level and less detailed any guidance was, the less onerous any compliance obligations were likely to be. However, one provider interviewed had a preference for very specific and prescriptive guidance because it was felt that this would make compliance easier.

4.3 Topics the guidance should address

In our interviews we asked participants about the particular topics and issues they thought the guidance should and should not address and, for each topic, what the guidance should broadly say. The following issues are discussed in this section:

- default option design;
- default option communication;
- governance issues; and
- other topics the guidance should address.

4.3.1 Default option design

With respect to default option design, many issues were raised in relation to who should be involved in the design of WPP default options, the investment principles that WPP default options should adhere to and how investments should be managed.

Involvement of employees, providers and EBCs in design process

In our interviews we discussed the respective roles that employees, pension providers and EBCs should have in the design of WPP default options.

In the majority of cases, those interviewed did not feel that it would be appropriate to involve individual employees more in the design or selection of default options. This was because it was felt that employees did not generally have the financial capability or interest in doing this. It was therefore felt that DWP's guidance should not attempt to encourage this type of employee involvement.

Where employers felt able to contribute in the design and selection process of default options, this was generally thought to be a good thing and to be encouraged – since employers sometimes had valuable information about their workforce which could be usefully reflected in the default design. Some participants nevertheless felt that there was currently some degree of uncertainty around the respective roles of employers and providers in the default design process compared to occupational schemes, where trustees have clear responsibility. It was felt that this lack of clarity was unhelpful and, in particular, could dissuade employers from getting involved in the default design process – resulting in a loss of a potentially valuable contribution from them. It was therefore felt that DWP's proposed provider guidance had a potential role to play in improving clarity. It was also suggested that DWP might usefully provide some advice for employers on their role in default option design (see Section 4.2.2).

Investment design and management

With respect to investment design and management, most participants felt that WPP default options now and in the future should reflect certain characteristics. The most important of these were felt to be:

- Use of de-risking close to retirement; and
- Some diversification of investments.

With respect to de-risking, most participants felt that the current lifestyle strategies typically in place for WPP default options were generally appropriate for members. While it was recognised that target-date funds can have particular advantages (particularly around ease of communication for members and implementing switches closer to retirement), a couple of issues were raised. Firstly, a number of providers commented that it is very costly to set up target-date funds; secondly, those who have or are considering launching target-date funds are not considering a fund for every year – instead, the funds are likely to be based on five-year intervals, e.g. a 2020 Fund, a 2025 Fund etc.

With respect to diversification, most felt that some diversification of assets was desirable for WPP default options. One of the issues discussed was the cost of such funds and that currently they are not too popular because they are more expensive than traditional lifestyle strategies using 100 per cent in global equities. However, some providers and EBCs felt that cost may be less of an issue in the future. Most participants interviewed felt that the current market was producing a good range of default options for employers to choose from in this respect and was therefore working well.

In relation to active (as opposed to passive) management of investments, most participants felt that passive management of default options was most appropriate – although it was recognised that the feasibility of this partly depends on which asset classes are used, since some asset classes require at least a degree of active management. In general, most participants felt that there was no 'one size fits all' rule and that the investment strategy taken should depend on the views of the particular provider, EBC, employer and employee profile. It was felt that current market practice delivered a good degree of choice for employers.

With respect to fees, most participants did not see a problem with regard to current fee levels and felt that it would be undesirable for caps on fees to be introduced in future. It was felt that the introduction of fee caps may serve to reduce innovation and choice in the market.

In relation to investment design and management overall, the majority of participants therefore felt that it was unnecessary and undesirable for DWP's guidance to attempt to alter market outcomes, since current practice was producing a good range of choice of default options for employers and a competitive market. Participants felt that guidance which sought to determine outcomes (for example, by specifying investment objectives for default options)

or be overly prescriptive would run the risk of limiting competition and reducing innovation, to the detriment of members.

'If the guidance is too prescriptive, it could be potentially dangerous'

(Provider interview)

4.3.2 Default option communication

Most participants recognised the problems that currently exist around members' lack of understanding about WPP schemes. Some of those interviewed suggested that DWP's guidance could have a role in improving this situation through encouraging more effective member communication.

The issue of how providers should manage members' expectations with regard to investment performance and effectively communicate the concept of investment risk to members was seen as particularly challenging for providers and an area that DWP's guidance could potentially address.

Some providers felt that it would be useful if documents similar to Statement of Investment Principles (SIPs) were included for all future default options and felt that it would be valuable for the guidance to recommend this. It was felt by some stakeholders that making these documents obligatory would help to ensure a certain minimum standard of communication with members.

'A statement of investment principles should be included in the default option. This will help ensure that fund managers stay within their mandates and would also increase communication with the consumer'

(Provider interview)

The information in a SIP was felt to be useful, regardless of exactly how it was conveyed (i.e. whether it was in a SIP, Key Features document, factsheet or something else).

4.3.3 Governance issues

Governance of WPPs was an issue of concern raised by providers and EBCs and some suggested that it was an area DWP's guidance could address.

Some thought it would be valuable if DWP's guidance were to set out what was deemed as 'best practice' in terms of WPP schemes' governance procedures. Although opinions differed, it was felt that this could perhaps cover issues such as:

- the regular monitoring and reviewing of the appropriateness and performance of default options by employers (our research found that the nature and frequency of fund reviews varies greatly); and
- the level of disclosure from providers in relation to their own internal review of funds, which it was thought may allow employers and members to better evaluate and compare the performance of different default options.

The issue of monitoring investment performance against individual member objectives was raised in some interviews. However, most providers and EBCs agreed that this would not be practical or beneficial, since many members do not actually know what their objectives are and, even if they did, communicating these and monitoring performance against them on an individual basis would be extremely difficult.

4.4 Other issues raised

A number of other issues were raised by participants in relation to the 2012 workplace pension reforms and DWP's proposed guidance and are discussed here.

4.4.1 Timing of guidance

Most of those interviewed (in particular, providers) said that it was important for the guidance to be issued as far in advance as possible, to give providers time to prepare for it. Issuing the guidance at least 12 months in advance of the start of automatic enrolment in 2012 was deemed necessary by most.

4.4.2 Relationship between DWP's guidance and the NEST (National Employment Savings Trust)

Many stakeholders raised the issue of the NEST and the concurrent consultation taking place on the design of the default option for this scheme.²⁸ Those interviewed felt that it was important that DWP's guidance took account of what was decided with regard to the default option for the NEST and that WPP default options should 'join up' with whatever is put in place for that. It was, however, recognised that the sheer size of the NEST is likely to mean that replication of particular investment strategies determined for the NEST may not be appropriate for individual WPP defaults, due to the significant differences in the scale of the schemes.

The possible impact of the NEST on the broader personal pension market was discussed frequently in our interviews. Many discussed the possibility of the NEST 'driving' or 'shaping' the market in some way, due to its sheer size and impact. The issue of performance comparisons between future WPPs and the NEST was also raised as an issue that may impact on the future development of the WPP market. It was felt that DWP should continue to discuss these issues with PADA.

²⁸ <http://www.padeliveryauthority.org.uk/investment-discussion-paper.asp>

4.4.3 Tying in DWP's guidance with other existing/proposed pension initiatives

Many providers raised the issue of how provision of default options may fit into the FSA Treating Customers Fairly (TCF) guidance.²⁹ The TCF guidance includes rules and principles that should apply to providers of contract-based schemes in relation to product design, communications and service, built on the premise that all customers should be treated fairly.

The main area of concern was with regard to changing default funds. Currently, providers find it difficult when they remove funds from their offering, as current FSA guidelines prevent them from forcing members to switch out of a fund. Therefore, in the future, if a provider feels that a default option is no longer suitable (for example, it no longer satisfies the FSA's TCF guidance), there is a concern for providers as they do not believe they can force members to move to the new default option. This could therefore result in some WPPs having legacy default options which differ from current default options.

Some stakeholders also discussed work currently being conducted by the Investment Governance Group (IGG)³⁰. The IGG is a new joint industry and government forum which was established following a National Association of Pension Funds review and government consultation into the Myners principles.³¹ It is chaired by the Pensions Regulator and is intended to implement an industry-led framework for the application of revised Myners principles and will focus on improving the way pension schemes are governed and investment principles are implemented and disclosed.

Participants were keen to see that DWP was aware of these other initiatives and that the guidance issued complemented the work undertaken in this area by others.

4.4.4 Use of consistent risk-rating for default options and risk preferences

Finally, some of the providers we interviewed discussed how valuable they thought a consistent risk rating of funds would be, as this would enable employers to more easily compare funds across providers. Such a measure would require the

²⁹ The FSA has defined six consumer outcomes which explain what it would like treating customer fairly principles to achieve for customers. <http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/index.shtml>

³⁰ <http://www.thepensionsregulator.gov.uk/igg/index.aspx>

³¹ The Myners Principles were intended to codify best-practice in investment decision-making. They were announced following a review of institutional investment in the UK by Paul Myners. Myners made a number of recommendations, including some around the governance and investment allocations of DC funds. Myners, 2001, Institutional investment in the UK: a review

use of some kind of standardised risk-rating method or tool, to allow funds to be consistently risk-rated against each other. Similar issues apply for individuals, where different risk-profiling questionnaires issued by different providers have the potential to categorise the same person into different risk categories.

In discussions with further stakeholders, including the FSA, it was recognised that achieving consistency in the risk-rating of funds and the risk-profiling of individuals would be very difficult to implement, since how risk is defined and measured is extremely complex. It is also fair to say that not everyone we spoke to was in favour of such a move. However, this is something that DWP may wish to canvass views on in the consultation guidance.

5 Recommendations for DWP's guidance

Previous chapters have discussed the current and emerging practice we have found in the use of Workplace Personal Pension (WPP) default options, and also outlined the opinions of those in the industry as to what the Department for Work and Pensions' (DWP's) future guidance for pension providers should look like. This chapter will summarise the key recommendations that arose from our research. Our recommendations are based solely on our research findings and do not take account of wider, potentially relevant evidence. It is important to recognise that this research will be one element of a range of evidence that DWP should draw on when developing its guidance.

5.1 Recommendation 1: DWP needs to clearly communicate why it is issuing this guidance

In the interviews, a number of participants were unclear about the need for DWP to issue guidance on this subject. They felt that there were risks to issuing guidance unnecessarily (in particular, that it may impact negatively on the market through stifling competition or innovation) and so that there needed to be sufficient justification for the guidance.

Some stakeholders felt that DWP's guidance should cover both WPP pensions and occupational (trust-based) schemes. Others had concerns around how DWP's guidance will fit in with other existing or proposed regulation – for example, the Financial Services Authority (FSA) Treating Customers Fairly (TCF) outcomes.

It is therefore important that DWP is very clear about the aims for the guidance it intends to provide and what the guidance is intended to do. In particular, DWP should clearly articulate:

- Why it has decided to issue guidance.
- What the Department's overall aims for the guidance are.
- Who/what the guidance is aimed at (and not aimed at) and why.

- How this guidance relates to other actions from Government around the 2012 workplace pension reforms.

5.2 Recommendation 2: DWP should consider extending the scope of the guidance or issuing additional guidance

During our industry interviews and policy development workshops there was much debate about the legislative arrangements, governance arrangements and guidance currently in place for Defined Contribution (DC) occupational (trust-based) schemes, in addition to the arrangements in place or planned for WPPs, which are the planned focus of the guidance.

A detailed analysis of DC occupational schemes was beyond the remit of our work, but these issues were raised consistently enough for the Department to consider including a question in the consultation on the use of default funds in WPPs that asks for further views on whether the guidance should be extended to cover both trust-based and contract-based schemes.

Others felt that DWP's guidance for providers should be supplemented with specific guidance for employers, as outlined in our next recommendation. This is also something we believe the Department should consider and perhaps consult on more widely.

5.3 Recommendation 3: The guidance should clarify the respective responsibilities of employers and providers in relation to WPP default options

A number of those interviewed highlighted that there was currently some degree of uncertainty around the respective roles of employers and providers in determining default options for WPPs. In particular, the role assigned to employers was sometimes unclear, which could dissuade employers from getting more involved in the process and helpfully contributing to the design of an appropriate default.

It is therefore important that DWP's guidance addresses this issue. In particular, the guidance will need to be very clear about what the particular requirements of employers and providers are in relation to the different steps involved in designing, determining and selecting a default option. DWP may wish to consider issuing additional guidance directed at employers as part of this. However, the DWP will need to discuss this with the FSA, to incorporate the FSA's requirements on providers and advisers.

5.4 Recommendation 4: DWP's guidance should be process driven, rather than being prescriptive on outcomes

In relation to default option design, the majority of those interviewed felt that it was unnecessary and undesirable for DWP's guidance to attempt to alter market outcomes, since current practice was producing a good range of choice of default options for employers and was resulting in a competitive and innovative market (a minority view promoting more prescriptive guidance is covered in 5.8). Participants felt that WPP default options now and in the future should have certain desirable characteristics (in particular, some diversification of assets and use of de-risking close to retirement) but that current market practice was generally producing these outcomes. In addition, it is common practice for providers to offer a range of default options.

Our research therefore suggests that DWP's guidance should concentrate on providing high-level principles and processes to guide providers in the design of defaults. This will help to ensure minimum standards in the market and provide some support to those providers who need it. The Department should consider what it considers an appropriate level of prescription to be for this guidance; the industry representatives we consulted firmly believe that guidance which is too prescriptive or outcome-focused should be avoided, as it may have anti-competitive effects and/or stifle innovation in the market, which may ultimately be to the detriment of members.

DWP may wish to consider including the following in guidance:

- Providing an outline of a decision-making process through which providers should go through (with employers) when designing and determining a default option;
- Recommending that providers consider the use of diversification of assets and de-risking close to retirement as a starting point for the design of a default – with explanations as to why these might be desirable characteristics for a default – but with the exact asset mix to be determined on an individual fund/provider basis;
- Providing commentary on other considerations that providers may wish to make with respect to the default design – for example, the use of active management versus passive management and the relative cost implications. Guidance could set out the issues and encourage providers to think about the issues involved, rather than making particular recommendations.

We note that a minority view was expressed on the appropriate regulatory approach to this area (discussed in Section 5.8).

5.5 Recommendation 5: DWP's guidance should encourage more effective communication with members

Poor member understanding of pensions in general and of investment risk in particular was an issue of concern highlighted in both our interviews and literature review. Most participants thought that DWP's guidance could potentially have an important role to play in improving outcomes in this area.

Managing members' expectations with regard to investment performance and effectively communicating the concept of investment risk to members was seen as particularly challenging for providers currently. Engendering confidence in pension saving so that members maintain regular contributions is vital and is likely to take on even greater importance post-2012. An element of this involves ensuring that individuals understand the long-term benefits of pension saving and do not opt out of schemes as a result of short-term fluctuations in investment performance.

Particular issues that DWP's guidance could address include:

- A requirement for WPP providers to issue a Statement of Investment Principles (SIP) or similar document. Although only some providers currently use SIPs, the majority say that they use a range of documents, such as 'Key features' documents or 'Fund factsheets', to cover similar issues. The information contained in a SIP was felt to be useful, regardless of how it was communicated. Imposing a requirement for providers to issue SIPs may be overly burdensome, but it would have the benefit of ensuring minimum standards of communication are met. It also needs to be clear that it would be the provider's responsibility to do this and not the employer.
- Recommended literature and suggested wording for providers to use to explain key investment concepts for members. For example, in explaining concepts of investment risk, risk-return trade-offs and the lifestyle strategy. This, again, would help to ensure that minimum standards are met.

A view was expressed that communication should be tailored to members' needs, and appropriate for their level of understanding.

5.6 Recommendation 6: DWP's guidance should consult on minimum governance requirements for providers

Governance of WPPs was an issue of concern raised by a number of participants and has also been discussed more broadly in the industry, as demonstrated by evidence from the literature review. It was also an area where those interviewed felt DWP's guidance could make a significant contribution.

Evidence suggests that providers may find it helpful if DWP were to outline what it deems to be 'best practice' in terms of provider governance structures. Equally, guidance to employers on their own governance and review structures could be valuable.

There are a number of areas which DWP's guidance could address, including:

- Recommending that providers put in place particular monitoring and review structures for the WPP default options. This might include more detailed suggestions from DWP around the frequency of reviews and their format – however, no optimal frequency was clear from our research, and this is something the Department may wish to consult on.
- Recommending that providers disclose more information in a more easily accessible format to employers on the performance of default options and findings from any internal investment reviews (as above) undertaken. This would help employers and members to compare the performance of different default options across the market and to increase their understanding of providers' views about the investment funds they offer.
- Recommendations around the factors that could trigger an automatic review of performance and the processes that should be put in place between employers and providers to undertake that review.

5.7 Recommendation 7: DWP could consult on how to achieve more consistent risk ratings

An issue that came up frequently in our interviews with providers was the inconsistency in how the risks of individual funds are rated, along with the inconsistency in how individuals' risk preferences are assessed. For example, some providers will rate the risk of particular asset classes differently; they may also have different risk scales, with some rating asset risks from 1 to 5, others from 1 to 10 and so on. Similar issues apply with individuals, where a person completing a risk assessment questionnaire may come out as having a 'cautious' risk appetite with one provider but could be considered as 'balanced' or even as having a 'high risk' appetite with another.

Achieving a measure of consistency in the risk-rating of funds and the risk-profiling of individuals would make comparisons between funds much easier and may also help pension providers and employers to gain a better understanding of a particular workforce. However, we note that not all participants were in favour of this. Discussions with stakeholders indicated that the issues are complex, but DWP may wish to canvass views on how such consistency could be achieved. This could be undertaken as part of the consultation guidance or as a separate consultation in the future.

5.8 A cautionary note

Because of the scope of this study, these recommendations are based solely on our research findings (i.e. current practice and the views of participants) and do not take account of wider, potentially relevant evidence, such as finance theory

or consumer preference theory. This is important for two reasons – firstly, because current practice cannot be assumed to be optimal from the point of view of member outcomes; and secondly, because even if current practice was optimal, it is possible that the optimal WPP default practice and design may change from 2012. For example, it is possible that the reforms may lead to changes in member participation, member characteristics and member risk preferences, which would lead typical optimal default design to become lower risk in future than it is today.

Distinct from the views of those we interviewed, we are of the opinion that there are a couple of issues that need to be borne in mind when taking forward these recommendations. The first issue is the relationship between current and future market practice. Evidence was found which suggests that current market practice and the views of participants are not always optimal – for example, default investment strategies sometimes do not align with finance theory and members' risk preferences are not always given the weight that one might expect. It is our recommendation that DWP takes further time to consider these findings, as they suggest that basing future practice on current practice may not be wholly appropriate.

The second issue is the approach the Department takes towards regulation. A (minority) view was expressed in the course of our research that a light-touch, process-based approach to regulation in this area is not appropriate and more heavy-handed, outcome-based regulation would be better. The rationale for this view was that outcomes are very important (e.g. affecting millions of people's retirement incomes) and consumers are typically ill-equipped to make judgements for themselves (because of issues such as poor financial capability). We recommend that DWP gives this view careful consideration.

Appendix A

Interview topic guides

In our research we conducted fieldwork interviews with three types of organisations – stakeholders, pension providers and employee benefit consultants. Below are the three interview topic guides we used across all interview categories.

Topic guide for provider interviews

Section A: Current demand for default funds and details on the funds offered

- Q1. Do you know the approximate proportion of your members that are in default funds? Have you researched any of the characteristics of people that are members of your default fund?
 - Q2. What is/are the current default fund(s) you offer?
 - Q3. Are your default funds life styled? If not, why not? If so, what approach does the life styling take?
What is your opinion on the desirable extent of equity exposure prior to the start of life styling?
 - Q4. What are the management investment styles used within the default funds?
 - Q5. To what extent do your default funds include diversification of assets (whether used & how used)?
 - Q6. Have you seen any change in the design of default funds over the last two years within your company?
 - Q7. Do you see a difference in the structure of default funds designed by EBCs as opposed to your organisation? If so, how do they typically differ (for example, do you offer the same default fund for all the schemes you operate whereas do EBCs offer a different funds depending on the particular circumstances of the client)?
-

Section B: Current practices in the design of default funds

- Q1. For what type of scheme does your organisation offer default funds?
- Q2. Please detail the differences in your design role for defaults in respect of Occupational Trust, GPP and Group Stakeholder Pensions?
- Q3. In terms of the current design of default investment options we would like to know:
- What is the process involved in designing default investment options?
 - Who is involved in the process?
 - Who in the organisations signs off on the decisions?
 - What guidance do they use?
 - What else do they take into account?
- Q4. What are your main objectives (in order of importance) in designing a default fund?
- Q5. Are your default funds designed using any evidence about the suitability of the funds for your members?
- Q6. Do your default funds specify an investment objective? If so, how are investment objectives set by your organisation?
- Q7. Do you have Statements of Investment Principles or similar document? If so what do they cover?
- Q8. Are EBCs/employers more/less involved according to which type of scheme it is? If so, in relation to which types of scheme?
- Q9. Can you discuss the role, influence and level of interaction amongst employers and EBCs in terms of designing default fund options? Can you explain further if there are any common characteristics among them? Can you explain if certain types of employers go for certain types of defaults? If you are not involved in the design of default funds (e.g. an EBC provides advice), do you have the option to veto a particular default fund?
- Q10. What is/are the benchmark(s) and investment objective(s) of the default fund(s) you offer?
- Q11. How do you monitor the ongoing suitability of your default funds against the investment objectives of your members?
- Q12. Do you have any other governance arrangements in place for your default funds? If so, what are they?
-

Section C: Information to inform the 2012 guidance notes

- Q1. This research will help to inform DWP's guidance for pension providers to follow when offering a default fund after automatic enrolment is introduced in 2012. Do you have any views on what the guidance should cover?
- Q2. Given that default funds will become more widely used from 2012, how might your organisations approach to default funds change? How do you see your role in designing the default options across different schemes changing? And why? If not, why not?
- Q3. Who should be involved in the design of the default funds?
- Q4. Will your organisation offer various default options for different individuals?
- Q5. Should default funds include diversification of assets (for example, non-equity investments in the growth stage of a lifestyle strategy)?
- Q6. Should the default options include a statement of investment principles or similar document?
- Q7. Should the ongoing suitability of default funds against the investment objectives of members be monitored in future? Should this be done regularly and if not, what in particular should trigger a review?
- Q8. Are there any other governance arrangements that you think are necessary for default funds? If so, what are they?
- Q9. Is there anything else related to default funds and 2012 reforms that we haven't already covered, that you think would be useful for us to know.
-

Thank and close.

Topic guide for stakeholder interviews

Section A: Views on current default fund practice

- Q1. Do you know the approximate proportion of people that are in default funds? Have you researched any of the characteristics of people that are members of default funds?
- Q2. Do you have any views on the suitability of current default fund provision?
- Q3. What are your views on the management investment styles used within default funds?
- Q4. What are your views on the extent to which default funds should include diversification of assets?
- Q5. What are your views on the most appropriate benchmarks/performance objectives to use when monitoring the performance of default funds?
- Q6. What are your views on the current level of governance in relation to default fund options?
- Q7. Have you seen any change in the design of default funds over the last two years in the market?
- Q8. Do you see a difference in the structure of default funds designed by EBCs as opposed to providers? If so, how do they typically differ?
- Q9. Do you have any concerns about the way in which default funds are currently designed and promoted?
- Q10. Do you think that members understand their default fund option? If not, what should providers/EBCs/employers do to rectify this problem?
-

Section B: Information to inform the 2012 guidance notes

- Q1. This research will help to inform DWP's guidance for pension providers to follow when offering a default fund after automatic enrolment is introduced in 2012. Do you have any views on what the guidance should cover?
- Q2. Who do you think should be involved in designing default funds?
- Q3. Given that default funds will become more widely used from 2012, how might your approach to default funds change? How do you see your role changing? And why? If not, why not?
- Q4. What are your views on how the design of default funds should change?
- Q5. Should the default options include a statement of investment principles or similar document?
- Q6. Should the ongoing suitability of default funds against the investment objectives of members be monitored in future? If so, who should do this? Should this be done regularly and if not, what in particular should trigger a review?
- Q7. Are there any other governance arrangements that you think are necessary for default funds? If so, what are they?
- Q8. Is there anything else related to default funds and the 2012 reforms that we haven't already covered that you think would be useful for us to know?
-

Thank and close.

Topic guide for EBC interviews

Section A: Current demand for default funds and details on the funds offered

- Q1. Do you know the approximate proportion of your clients' members that are in default funds? Have you researched any of the characteristics of people that are members of these default funds?
- Q2. What types of default funds are used by your clients?
- Q3. Are your default funds typically life styled? If not, why not? If so, what approach does the life styling take?
What is your opinion on the desirable extent of equity exposure prior to the start of life styling?
- Q4. What are the management investment styles typically used within the default funds?
- Q5. To what extent do your default funds include diversification of assets (whether used & how used)?
- Q6. What is/are the typical benchmark(s) and investment objective(s) of the default fund(s) you offer?
- Q7. Have you seen any change in the design of default funds over the last two years?
- Q8. Do you see a difference in the structure of default funds designed by providers as opposed to your organisation? If so, how do they typically differ?
-

Section B: Current practices in the design of default funds

- Q1. For what type of scheme do you currently advise on default funds?
- Q2. Please detail the differences in your role for defaults in respect of Occupational Trust, GPP and Group Stakeholder Pensions?
- Q3. In terms of the current design/selecting of default investment options we would like to know:
- What is the process involved in designing/selecting default investment options?
 - Who is involved in the process?
- Q4. What are your main objectives (in order of importance) in designing/selecting a default fund?
- Q5. Are your default funds designed/selected using any evidence about the suitability of the funds for your members?
- Q6. Do your default funds specify an investment objective? If so, how are investment objectives set by your organisation?
- Q7. How do you monitor the ongoing suitability of your clients' default funds against the investment objectives of your clients' members?
- Q8. Do you have Statements of Investment Principles or similar documents? If so, what do they cover?
- Q9. Can you explain if certain types of employers go for certain types of defaults?
- Q10. Do you have any other governance arrangements in place for your default funds? If so, what are they?
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Section C: Information to inform the 2012 guidance notes

- Q1. This research will help to inform DWP's guidance for personal pension providers to follow when offering a default fund after automatic enrolment is introduced in 2012. Do you have any views on what the guidance should cover?
- Q2. Given that default funds will become more widely used from 2012, how might your approach to default funds change? How do you see the role of personal pension providers in designing the default options across different schemes changing? And why? If not, why not?
- Q3. Who should be involved in the design of the default funds?
- Q4. Do you think feel that personal pension providers should offer various default options for different individuals?
- Q5. Should default funds include diversification of assets (for example, non-equity investments in the growth stage of a lifestyle strategy)?
- Q6. Should the default options include a statement of investment principles or similar document?
- Q7. Should the ongoing suitability of default funds against the investment objectives of members be monitored in future? Should this be done regularly and if not, what in particular should trigger a review?
- Q8. Are there any other governance arrangements that you think are necessary for default funds? If so, what are they?
- Q9. Is there anything else related to default funds and the 2012 reforms that we haven't already covered that you think would be interesting for us to know?
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Thank and close.

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